

5. CNBC BASIC TECHNICAL ANALYSIS E-MAIL

A basic definition of technical analysis is "a study of price action (charts) in order to forecast future price action." Those that apply technical analysis assume a few things: markets trend and history repeats itself. Trend is an important concept because many technical approaches rely on identifying a trend and trading in the direction of that trend. "History repeats itself" is another way of saying that the same patterns occur over time, and that these same patterns indicate either bullishness or bearishness.

So, how can you identify trend, and what are some common patterns that indicate directional setups?

The simplest and most common technical tools include basic indicators such as the Simple Moving Average (SMA), RSI (Welles Wilder's Relative Strength Index), and chart patterns such as head and shoulders and triangles.

The example below is of a daily EUR/USD bar chart from approximately October 2004 to October 2006. The red line plotted with the bars is a 200-day simple moving average (SMA). A Simple Moving Average is just what it sounds like: the average of a specific body of data. In this case, each value along the 200-day SMA is the average of the last 200 closing prices. The 200-day SMA is a common tool used to identify a long-term trend. The trend is considered up when price is above the moving average and down when price is below the moving average. The blue oscillator plotted below the price bars and moving average is a 14-period RSI (14 is the most common input—a smaller input such as 9 will yield a more volatile indicator and a larger input such as 21 will yield a less volatile indicator). Price is considered "overbought" when the indicator is above 70 (upper-dashed line) and "oversold" when price is below 30 (lower-dashed line). Traditionally, a cross above 30 is a buy signal and a cross below 70 is a sell signal. By combining the 200-day SMA and RSI during the October 2004 – 2006 period, you could have made a lot of money in the EUR/USD!



Chart patterns indicate whether price is likely to continue in the direction (continuation patterns) of the trend or reverse (reversal patterns). A common continuation pattern is the triangle pattern. The triangle shown below is a contracting triangle since the two lines that form the triangle converge. In this specific case, the EUR/USD rallied from 1.1757 to 1.2460 (4/26/04 –7/16/04) before forming the triangle. The triangle gave way to a bullish breakout in late September. A common reversal pattern is a head-and-shoulders pattern. A well-defined inverse head-and-shoulders pattern unfolded from early July 2005 to early April 2006. For an inverse head-and-shoulders pattern, there is:

1. a downtrend into point A;
2. a corrective rally to point B;
3. a drop to a new low in point C;
4. an advance that approaches the B peak, which is point D;
5. a third decline that does not reach the head, which is point E;
6. a close above the "neckline" (a line that connects points B and D), which is point F and the buy point.

This inverse head and shoulders signaled the 2006 low and the beginning of a major EUR/USD bull run.



Both of these chart patterns led to superb EUR/USD-long trades. Still, trading is all about confidence, and the more signals you have that a market will move in a specific direction, the more confidence you will have in trading that market. In other words, combine patterns with indicators, such as moving averages, in order to find the absolute best trades. The breakouts from the aforementioned patterns occurred when the EUR/USD was crossing above its 200-day SMA. You would have more confidence with this knowledge and be more likely to increase the size of your trade.

*Leveraged foreign exchange trading carries a high level of risk, and may not be suitable for all investors. The possibility exists that you could sustain a loss of some or all of your initial investment and therefore you should not invest money that you cannot afford to lose.

EURUSD - Daily FOREX L=1.46728 -0.00101 -0.07% B=1.46728 A=1.45743 O=1.46828 H=1.46877 Lo=1.45312 C=1.45728 V=0 Max-Avg 1 Line (Close,200,0) 1.40750



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